

**Statement of  
Sheila C. Bair, Chairman,  
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On  
Recent Events in the Credit and Mortgage Markets  
And  
Possible Implications for U.S. Consumers and the Global Economy  
before the  
Financial Services Committee, U.S. House of Representatives  
2128 Rayburn House Office Building  
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Chairman Frank, Ranking Member Bachus, and members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) on the credit and mortgage markets. Events in the financial markets over this summer present all of us here today -- regulators, policymakers, and industry - with serious challenges. The FDIC is committed to working with Congress and others to ensure that the banking system remains sound and that the broader financial system is in position to meet the credit needs of the economy, especially those of creditworthy households currently in distress. In my testimony today, I will discuss the developments that led to the current market disruptions, report on the condition of the banking industry, and describe ways to address some of the lessons we have learned from the events of recent months.

#### The Roots of the Current Problem

The chronology of the events that have led up to the present situation demonstrates how weak credit practices in one sector can lead to a wider set of credit market uncertainties that could affect the broader economy. Although these events have yet to fully play out, they underscore my longstanding view that consumer protection and safe and sound lending are really two sides of the same coin. Failure to uphold uniform high standards in these areas across our increasingly diverse mortgage lending industry has resulted in serious adverse consequences for consumers, lenders, and, potentially, the U.S. economy.

At the beginning of the most recent mortgage lending growth period, in 2002 and 2003, we witnessed a record boom in the volume of mortgage originations, driven primarily by the refinancing of existing mortgages. By mid-2003, as long-term mortgage interest rates fell toward generational lows, virtually every fixed-rate mortgage in America became a candidate for refinancing. The result was a wave of refinancing activity that was dominated by prime, fixed-rate loans. During 2003, some 64 percent of all mortgage applications were for refinancing, and over 80 percent were for fixed-rate loans. By the end of 2003, more than three quarters of U.S. mortgages included in non-agency securitizations were less than three years old.

With lower interest rates came higher rates of home price appreciation. As measured by the OFHEO Home Price Index, U.S. home price appreciation measured 5 percent or less in every year during the 1990s. But starting in 2000, U.S. home price appreciation rose to annual rates of between 6 percent and 8 percent followed by double-digit increases in both 2004 and 2005. This home price boom was concentrated at first in metropolitan areas of California, the Northeast, and Florida, and it then spread by the middle of the decade to much of the Mountain West and other cities further inland. While home prices were effectively doubling in a number of boom markets, median incomes grew much more slowly, severely reducing the affordability of home ownership despite the benefit of historically low interest rates.

## **Changes in Mortgage Lending**

Home price appreciation helped set the stage for dramatic changes in the structure and funding of U.S. mortgage loans. To the extent that prime borrowers with a preference for fixed rates had already locked in their loans by 2003, the mortgage industry began to turn its attention -- and its ample lending capacity -- toward less creditworthy borrowers and home buyers struggling to cope with the high cost of housing. One result was a shift in the overall market from refinancing toward purchase financing, which rose to more than half of originations in 2004, 2005, and 2006. Another result was a larger share of originations for subprime loans, which more than doubled in 2004 to 18 percent of originations and then peaked at just over 20 percent in 2005 and 2006. Declining affordability in high-priced housing markets also contributed to a shift toward nontraditional loans such as interest-only and payment-option mortgages. Among mortgages packaged in non-agency securitizations, nontraditional mortgages rose from just 3 percent of nonprime originations in 2002 to approximately 50 percent by early 2005.<sup>1</sup>

The growth in nontraditional lending was associated with a larger expansion in so-called "Alt-A" mortgages, or loans made to presumably creditworthy borrowers where the terms and/or documentation of the loan fall short of the requirements placed on "conforming" loans.<sup>2</sup> In addition, borrowers who lacked the requisite 20 percent down payment required for conforming loans could, in the nonconforming market, arrange to borrow their down payment through a second mortgage, or piggyback loan, and thereby avoid the cost of mortgage insurance that has traditionally been imposed on borrowers with high loan-to-value ratios. While nontraditional mortgages, subprime mortgages, and home equity loans were not new to the marketplace in 2004, they had never been originated on such a wide scale prior to this time.

Expansion of nonconforming mortgage lending has been facilitated by an increasingly diverse set of origination and funding channels. Origination channels include both FDIC-insured institutions and their finance company affiliates, as well as mortgage brokers and stand-alone finance companies that fall outside direct federal supervision. Funding channels include banks and thrift institutions, the housing-related Government Sponsored Enterprises (GSEs), GSE-sponsored mortgage pools, and, increasingly, private issuers of asset-backed securities (ABS). But an unmistakable trend that stands

out as a driver of the changes we have seen in the mortgage industry has been the rise in the share of mortgages funded by ABS issuers, which rose from 8.5 percent in 2003 to 18.7 percent by 2006.<sup>3</sup> The availability of funding through private ABS facilitated growth in the "originate and sell" business model, under which a broad range of brokers and correspondents participate in originating mortgage loans without the need to provide permanent financing themselves. This model was pioneered by lenders selling conforming mortgages to the GSEs, but in recent years private ABS issuance has become a primary channel for the funding of subprime and Alt-A mortgage loans. Subprime and Alt-A loans together stood behind 77 percent of all private ABS outstanding as of May of this year.<sup>4</sup>

In the absence of GSE sponsorship, private ABS issuers were able to enhance the marketability of their obligations by structuring them into senior and subordinate tranches. The end result of this process was the creation of trillions of dollars in investment grade mortgage-backed securities (MBS) that were purchased by a range of domestic and international investors, along with a smaller volume of higher-risk securities that were better suited to hedge funds and other investors with an appetite for yield and a greater tolerance for risk.

In hindsight, it is clear that the strong performance of these securities -- both in senior and subordinate tranches -- during the period of low interest rates and rapid home price appreciation helped to obscure their true risk. While times were good, an excess volume of credit flowed to mortgages in general and nonconforming mortgages in particular. Ready access to market-based funding, in turn, contributed to what is recognized now as a serious weakening of underwriting practices. This deterioration of underwriting practices is perhaps best described by the term "risk layering," which regulators have used to describe the practice of allowing a number of different potentially risky underwriting attributes (such as low credit score, high loan-to-value, low or no documentation of income, etc.) in the same loan. These practices tend to compound the risk of default, particularly when permitted in combination. As long as home prices were rising, even these layered risks were often overlooked by lenders, borrowers, and investors. Rising prices delivered capital gains to existing homeowners that could be tapped through home equity loans or "cash-out" refinancing, thereby making default a relatively rare occurrence.

Another consequence of the easy credit availability afforded by lower underwriting standards and rising home prices was an increase in both the misuse of credit by speculators and perpetrators of fraud. While housing booms inevitably attract speculative investment, the prevalence of low documentation, low down payment loans in this cycle dramatically lowered the barriers to entry in this segment of the housing market. During 2006, loans to investors or for second homes made up a reported 7 percent on non-agency subprime securitized mortgages.<sup>5</sup> FBI data show that the number of suspicious activity reports (SARs) indicating mortgage fraud rose from fewer than 7,000 in 2003 to more than 35,000 in 2006.<sup>6</sup>

Meanwhile, the increasingly diverse array of loan types available to borrowers in this cycle invited unscrupulous lenders to impose onerous terms on less sophisticated borrowers who might not fully understand the true costs and risks of these loans. The culmination of this process was the subprime hybrid "2/28" or "3/27" mortgage, which typically combines a substantial increase in the interest rate and monthly payment on the loan after the initial two to three year starter period with a substantial prepayment penalty that limits the ability of the borrower to refinance the loan until that starter period is over. Third party estimates of monthly payment "resets" on subprime adjustable-rate mortgages (ARMs) through year-end 2008 suggest the potential for serious financial distress for over 1.5 million households.<sup>7</sup> The Mortgage Bankers Association estimates that nearly 490,000 subprime loans were already seriously delinquent or in foreclosure as of March 2007.<sup>8</sup>

These looming payment resets are just one of a series of ongoing developments that amply demonstrate the consequences of failing to uphold a strong, uniform set of lending and underwriting standards across the mortgage industry. The transactional nature of the "originate and sell" model has contributed to lending practices that have damaged the immediate interests of consumers, mortgage lenders and mortgage investors, and now pose a risk to the broader economy. The housing boom has given way to declining home prices in an expanding list of U.S. metropolitan areas. Mortgage delinquencies and foreclosures are on the rise not only in subprime portfolios, but also in Alt-A portfolios, where risk layering is now contributing to credit problems that are no longer being masked by home price appreciation.

### **The Impact of Poor Mortgage Underwriting on Other Markets**

The full dimensions of the problem in mortgage markets started to become clear late last year, as analysts noted the marked deterioration in the performance of recent loan originations. However, it was not until the middle of this year that we began to see a substantial number of downgrades in the credit ratings of some types of MBS. These downgrades have contributed to generalized uncertainty about the value of MBS and have in turn triggered redemptions at hedge funds, margin calls, and episodes of illiquidity in commercial paper and other areas of global financial markets.

Since the beginning of June 2007, the securities rating agencies have downgraded more than 2,400 tranches of residential MBS. Ratings downgrades led to decreased liquidity for many financial assets, not just those known to have problems. For example, the liquidity for MBS that were downgraded declined, but so did the liquidity for many securities where the ratings remained unchanged. The uncertainty that now pervades this market -- which is directly attributable to underwriting practices that are unsafe, unsound, predatory and/or abusive -- has seriously disrupted the functioning of the securitization market and the availability of mortgage credit.

Investor concern about ratings has become particularly acute in the markets for Asset-Backed Commercial Paper (ABCP) and repurchase agreements -- investments where credit risk is expected to be low and liquidity to be high. Investors' trust in the ratings

assigned to the bonds and other assets used as collateral for ABCP and repurchase agreements has been integral to the orderly and efficient working of these markets. However, when ratings came into question, investors redeemed these investments and sought safety in short-term Treasury securities. During the third week in August, the volume of commercial paper outstanding dropped \$90 billion, or 4.23 percent, the largest percentage decline since 2000. Almost 80 percent of the decline was in ABCP, which accounts for about half of all commercial paper. When commercial paper investors could not be found, some ABCP issuers were forced to use liquidity backstop funding to finance assets causing the rates on commercial paper to increase. Risk aversion among commercial paper investors caused them to err on the side of caution when deciding which ABCP to renew.

Credit concerns now extend more broadly to leveraged commercial lending.<sup>9</sup> During August 2007, credit market conditions became more challenging as investors and lenders worked to understand where the concentrations of credit risk would be most problematic. Most vulnerable were highly leveraged, poorly diversified and illiquid entities, including some hedge funds which had been buyers of syndicated loans. Illiquidity in the non-agency MBS market caused some fund managers to meet margin calls by selling non-distressed assets, contributing to weaker asset prices beyond the mortgage markets. Uncertainty about future asset prices reduced the appetite for funding for various asset classes, including leveraged loans. In some cases, originators were unable to find buyers for these loans and had no choice but to fund loans that they had originally intended to hold temporarily. Linkages between the credit and equity markets also became more apparent as the ability to raise debt funding to take public companies private came into question, causing the equity prices of targeted companies to decline.

### **The Current Condition of the Banking Industry**

Because insured financial institutions entered this period of uncertainty with strong earnings and capital, they are in a better position both to absorb the current stresses and to provide much needed credit as other sources withdraw. It is in times of financial stress that the role of federal deposit insurance becomes evident in promoting stability. Insured deposit accounts give consumers a safe place to put their money during times of uncertainty, and confidence in the safety of their deposits helps to preserve the liquidity and integrity of the financial system.

As the current period of financial stress began, both the banking industry and the deposit insurance system were sound. Two weeks ago, the FDIC released second quarter 2007 financial results for the 8,615 FDIC-insured commercial banks and savings institutions. The results reported in the Quarterly Banking Profile describe an industry with very solid performance. Second-quarter earnings were the fourth highest quarterly total on record -- only 3.5 percent below the all-time high. Also, the industry's return on assets of 1.21 percent remained strong by historical standards. Although the number of unprofitable institutions increased during the quarter, more than 90 percent of all FDIC-insured institutions were profitable. Nearly all institutions could be considered "well

capitalized" according to the standards for Prompt Corrective Action, and the industry's leverage ratio remained above 8 percent.

Yet, it is clear that conditions for banks and thrifts are not as favorable as in the recent past. The interest rate environment continues to be difficult for financial institutions. More than two out of three institutions reported net interest margins in the second quarter that were below levels reported at the same time last year. The industry continues to generate strong noninterest income -- in the most recent quarter, noninterest income was 9 percent higher than a year earlier. However, some components of noninterest income, such as trading revenue and investment banking fees, can be subject to downward movements in times of credit market distress.

Of most concern, credit quality is likely to get worse before it gets better. Net charge-offs totaled \$9.2 billion in the second quarter -- the highest quarterly total since the fourth quarter of 2005 -- and were 51 percent higher than in the second quarter of 2006. Net charge-offs of 1-4 family residential mortgage loans increased 144 percent from the prior year period, to \$715 million. Noncurrent (90 days or more past due or in nonaccrual status) 1-4 family residential mortgage loans represented 1.26 percent of all such loans at the end of June -- the highest noncurrent rate for these loans since the first quarter of 1994.

Based on the challenges facing the banking industry, it is important to consider what recent market events may mean for banks and thrifts going forward. The current situation mostly affects lenders who rely on the "originate and sell" model, and this way of doing business is under intense pressure. There is a chance that larger volumes of loans may find their way onto bank and thrift balance sheets than has been the case in recent years. In some cases, insured institutions may choose to grow their loan portfolios. In other situations, banks may find themselves holding assets on a long-term basis that they planned to fund only on a short-term basis, if at all.

Many credit needs will have to be funded in the coming months. In terms of mortgage credit, an estimated \$353 billion in subprime mortgages will reset between now and the end of 2008.<sup>10</sup> Opportunities may exist to originate and hold a range of nonconforming mortgage loans for which secondary market liquidity has receded. The commercial loan portfolios of banks and thrifts are also likely to expand as a result of a more difficult secondary market for commercial credit. Total outstanding commitments to fund U.S. leveraged loan deals in the second half of 2007 have been estimated at approximately \$200 billion.<sup>11</sup> Moreover, the issuers of the approximately \$1 trillion in ABCP outstanding may increasingly look to depository institutions as an alternative financing source when this paper comes due. Some of the leveraged loans and ABCP may reach insured institutions' balance sheets directly, as banks fund these deals through previously established backup financing arrangements, retain credits they originally intended to sell, or purchase this paper in the open market.

The problems in the credit markets represent both a challenge and an opportunity for FDIC-insured depository institutions. Among the challenges for the industry are the

increased credit losses that already exist and are likely to continue in coming quarters. If the housing downturn continues, some institutions that are currently in good shape could face capital challenges resulting from losses in mortgage related assets. In general, however, the industry is well-positioned to manage these losses. This situation may also create opportunities for insured institutions to expand market share and improve interest margins as some credit market funding shifts from the secondary market to banks and thrifts. Growth of portfolios, if it occurs, would pose a risk management challenge for many institutions, and institutions that expand their loan portfolios will have to maintain sufficient capital to support that growth. However, the currently strong capital base of the industry places it in a position to be a more important source of financing for U.S. economic activity through this difficult period.

### **Addressing the Problems**

A full evaluation of lessons learned from this episode will require more time and more study. However, there are a number of near-term priorities that should be pursued now to minimize the adverse consequences of the present turmoil and begin to lay the groundwork for a more vigilant and more uniform regulatory approach going forward. In the near term, the FDIC will continue to fulfill its roles as supervisor and deposit insurer by defining and enforcing appropriate lending standards, working to suggest options for borrowers who find themselves facing financial distress, and monitoring the condition of insured institutions.

The FDIC continues to closely monitor the situation in the markets. While others -- including several of my counterparts at the table today -- are working to address the broader market issues, the FDIC will continue to play a significant role as the primary federal regulator of 5,214 commercial banks and state savings banks and as the deposit insurer for 8,615 banks and thrifts. Most of the largest mortgage lenders either are, or are affiliated with, an insured depository institution. Federal deposit insurance will assure the continued viability of a source of funding and liquidity -- in the form of deposits -- that is a vital underpinning of our financial system.

### **Improving Lending Standards**

The FDIC and other federal banking agencies conduct regular examinations, monitoring and reporting on the mortgage activities of insured institutions. Further, the agencies have taken a series of steps to address developments in the mortgage market from both a safety and soundness and a consumer protection perspective. For example, in September 2006, the agencies issued Interagency Guidance on Nontraditional Mortgage Product Risks to address concerns about offering interest-only and payment-option adjustable rate mortgages to borrowers for whom they were not originally designed. The guidance not only reminded bankers to carefully manage the risks associated with these products, it also emphasized that consumers should be provided with clear and accurate information about these products at the time they are choosing a loan or deciding which payment option to select.

On January 22, 2007, the FDIC issued its Supervisory Policy on Predatory Lending that describes certain characteristics of predatory lending and reaffirms that such activities are inconsistent with safe and sound lending and undermine individual, family, and community economic well being. The policy also describes the FDIC's supervisory response to predatory lending, including a list of policies and procedures that relate to consumer lending standards.

Since the subprime market raised additional concerns, the agencies issued a Statement on Subprime Mortgage Lending on June 29, 2007. This statement makes clear that lenders should follow two fundamental consumer protection principles when underwriting and marketing mortgages. First, a loan should be approved based on a borrower's ability to repay it according to its terms (e.g., not just at the initial rate). Second, consumers should be provided with the information necessary to help them decide if a loan is appropriate for their needs. The statement cautions that such communications should not be used to steer consumers to subprime products to the exclusion of other institution products for which consumers may qualify. Relying on these principles, lenders can offer mortgages that meet the needs of most subprime customers in a safe and sound manner.

Although the FDIC and others recognized the changing nature of the mortgage lending industry, it is fair to say that the regulatory community, ratings firms, and others in the industry failed to fully appreciate the depth of the underwriting problems and the severity of subprime payment resets until late last year. Even though it was not reasonable to expect that home prices would continue to rise at double digit rates indefinitely, many of the emerging risks were masked by home appreciation. However, it also was apparent that subprime and nontraditional mortgages were growing asset classes that could expose many borrowers to payment shock. Seeing this, consumer advocacy groups were among the first to suggest that changes in the market might lead to more delinquencies and foreclosures.

### **Assisting Troubled Borrowers**

The federal banking agencies have been working together for many months to address issues surrounding subprime mortgages, especially the possibility of increased foreclosures, and we have sought ways to help creditworthy borrowers who are currently in mortgages that are or soon will be unaffordable. In April, the FDIC and the federal banking agencies issued a Statement on Working with Mortgage Borrowers, which encourages financial institutions to work constructively with residential borrowers who are financially unable to make their home loan payments. The June Statement on Subprime Mortgage Lending reinforces the April Statement, encouraging institutions to work constructively with residential borrowers with troubled loans. In addition, in July, the agencies issued proposed updates to the Interagency Questions and Answers Regarding Community Reinvestment, including revisions which highlight that institutions can receive CRA consideration for foreclosure prevention programs for low- and moderate-income homeowners, consistent with the April and June Statements.

The FDIC, along with the other banking agencies, has jointly hosted a series of forums on the issues surrounding subprime mortgage securitizations. These forums have engaged market participants at every level in identifying barriers to working with borrowers to avoid foreclosure and developing solutions to permit borrowers to retain their homes. Importantly, every forum participant agreed that foreclosure of owner-occupied homes was rarely the best option for investors or borrowers.

Building on the information learned from these meetings with participants in the securitization markets, yesterday, the FDIC, the other federal banking agencies, and CSBS issued a Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages that provides instructions to the agencies' supervised institutions servicing securitized mortgage loans. The Statement urges institutions to review the governing documents for the securitization trusts to determine the full extent of their authority to restructure loans at risk of default. Most securitization documents allow servicers to proactively contact borrowers at risk of default, assess whether default is reasonably foreseeable, and, if so, apply loss mitigation strategies designed to achieve sustainable mortgage obligations that keep borrowers in their homes to the extent possible. The Securities and Exchange Commission and the U.S. Department of the Treasury have indicated that such servicing activities are consistent with acceptable accounting practices and controlling tax principles. As significant numbers of hybrid adjustable rate mortgages are scheduled to reset throughout the remainder of this year and next, the FDIC is encouraging institutions servicing such loans to carefully review the authority they have under the governing agreements and pursue prudent loan restructurings with borrowers to avoid unnecessary foreclosures.

It is equally important that when working with financially stressed residential borrowers, servicers should avoid temporary measures that do not address the borrower's ongoing difficulty with unaffordable payments. Institutions are encouraged to work toward long-term sustainable and affordable payment obligations that will provide stability for servicers and investors as well as borrowers. Clearly, fixed rate obligations provide the best opportunity to long-term stability. In developing a strategy to address payment difficulties, it is essential that servicers, as well as lenders, realistically evaluate the borrower's ability to repay the modified loan. One methodology commonly used by servicers is an analysis of the borrower's resulting debt-to-income (DTI) ratio. The DTI ratio should include the customer's total monthly housing-related payments (i.e., principal, interest, taxes, and insurance) as a percentage of their gross monthly income. In issuing the interagency statement, the FDIC and CSBS noted that, absent mitigating circumstances, resulting DTI ratios exceeding 50 percent will increase the likelihood of future difficulties in repayment and delinquencies or defaults.

Another effort to help troubled homeowners involves the FDIC's Alliance for Economic Inclusion. The Alliance is the FDIC's national initiative to form a network of local coalitions around the country charged with helping underserved populations in nine particular markets across the United States. As part of this effort, the Alliance for Economic Inclusion has partnered with NeighborWorks® America's Center for Foreclosure Solutions to promote foreclosure-prevention strategies for consumers at

risk of foreclosure. Within each of the nine markets, the partnership is conducting outreach to identify and help homeowners at risk of foreclosure, work to increase lenders' support for foreclosure intervention, and promote best intervention practices in mortgage servicing programs for consumers at risk of foreclosure who could qualify for alternate financing.

Working with our federal and state regulatory counterparts, insured institutions, the Congress, and other parties, we are eager to help find solutions for borrowers who have mortgages they cannot afford.

## **Supervising Financial Institutions**

The FDIC is responsible, along with the other federal banking agencies and state regulators, for monitoring insured institutions that may have exposure to troubled mortgages or related assets. Recently, exposures have manifested in the form of liquidity and funding issues for a small group of institutions that are significantly involved in mortgage banking activities. For the largest institutions whose actions can have a significant impact on the marketplace itself, the FDIC is working with each institution's primary federal regulator to monitor their on- and off-balance sheet activities. The FDIC has stepped up its offsite monitoring of other institutions with potential mortgage pipeline exposures and in some cases have made unscheduled visits to ascertain the effect of the current market interruption on their liquidity and capital. In the longer term, a significant downturn in the housing market may lead to asset quality deterioration for a larger number of institutions with heavy exposures to single-family construction loans as well as nontraditional and subprime mortgages. The vast majority of insured institutions are well positioned by virtue of their strong capital to deal with adverse conditions. Experience suggests that credit quality problems arising from economic conditions tend to play out over time. FDIC examination processes are well-suited to deal with these types of problems should they develop. The FDIC and our fellow regulators will remain vigilant as credit conditions change.

It also is important that financial institution supervisors do all they can do to improve consumer protection and make certain that rules for all market participants are consistent. The uncertainty that now pervades the marketplace -- which is in many respects attributable to underwriting practices that were sometimes speculative, predatory, or abusive -- has seriously disrupted the functioning of the securitization market and the availability of mortgage credit. In light of the credit quality problems that have already arisen and may yet emerge from MBS, investor appetite for all but high-quality, agency-conforming mortgages has been significantly reduced. Restoring the proper functioning of essential capital market processes requires that regulators better define and enforce the principles of sound underwriting for mortgage loans for all mortgage lenders, not just FDIC-insured institutions.

The Board of Governors of the Federal Reserve System (FRB) has recently solicited public comment on how to utilize its rulemaking authority under the Home Ownership and Equity Protection Act of 1994 (HOEPA) to prevent predatory lending practices. We

encourage the FRB to exercise its authority to set strong national standards for all lenders that will eliminate abusive, unfair, or deceptive lending practices and consumer information, which have contributed to deterioration and uncertainty in our financial markets. The FRB's authority to reach all mortgage loan originators through a rulemaking under HOEPA gives it an exceptional opportunity to impose uniform and fair rules that protect consumers in their transactions with all mortgage loan originators, while maintaining a level playing field for banks, non-banks, and mortgage brokers.

The shakeout in the mortgage market also holds lessons for processes that rely on modeling to determine appropriate capital levels. A purely historic look at mortgage loan data would have suggested much lower capital levels under the advanced approaches of Basel II. Capital requirements generated under these assumptions would likely have been insufficient given the poor performance experienced in many of the nontraditional mortgage products in the marketplace. More broadly, it will be no less difficult to fully understand the risks in more complex and dynamic products, such as collateralized debt obligations, credit derivatives and leveraged lending. Some products and markets could pose risks and stresses that prove impossible to quantify. Banks and supervisors can attempt to build an appropriate level of stress into the advanced capital calculations of Basel II, but the lag in identifying and understanding changes in market practices may make this very difficult. Recent events have clearly demonstrated that it is essential that institutions maintain strong capital levels during the implementation of Basel II.

## **Conclusion**

Poor, and in some cases predatory, underwriting in recent years has led to two serious consequences. First, it has created financial distress for many households. Second, it has disrupted broader credit markets that rely on the securitization process. While the resulting loss of credit capacity is expected to be temporary, it is important that during this period the banking industry is well-positioned to supply credit, especially for home mortgages. We must take additional steps to ensure that our financial system treats borrowers fairly and allows investors to have confidence in the underwriting that supports complex financial instruments. We look forward to working with this Committee to address the many issues raised by recent market developments. This concludes my statement. I will be happy to answer any questions the Committee might have.

- 1 1 "Breaking New Ground in U.S. Mortgage Lending," FDIC Outlook, Summer 2006, [http://www.fdic.gov/bank/analytical/regional/ro20062q/na/2006\\_summer04.html](http://www.fdic.gov/bank/analytical/regional/ro20062q/na/2006_summer04.html).
- 2 Conforming loans are loans that meet the standards for purchase or securitization by one of the government-sponsored enterprises (GSEs).
- 3 Federal Reserve, Flow of Funds, Table L.218. As of March 2007, the share of U.S. mortgage debt held by ABS issuers was 18.8 percent.
- 4 FDIC calculations based on the Loan Performance Securities database.

- 5 "An Introduction to the Subprime Mortgage Sector," Bank of America RMBS Trading Desk Strategy, June 27, 2007.
- 6 Financial Crimes Report To The Public, Fiscal Year 2006.  
[http://www.fbi.gov/publications/financial/fcs\\_report2006/financial\\_crime\\_2006.htm](http://www.fbi.gov/publications/financial/fcs_report2006/financial_crime_2006.htm)
- 7 FDIC estimates based on payment reset projections provided by Credit Suisse.
- 8 Mortgage Bankers Association, National Delinquency Survey, First Quarter 2007.
- 9 Leveraged commercial loans are those where the obligor's post-financing leverage as measured by debt-to-assets, debt-to-equity, cash flow-to-total debt, or other such standards unique to particular industries significantly exceeds industry norms for leverage.
- 10 "Mortgage Liquidity du Jour: Underestimated No More," Credit Suisse, March 12, 2007. Amount represents the study's estimated subprime mortgage resets from September 2007 through December 2008.
- 11 "Company Flash," Citigroup Global Markets, July 26, 2007.

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